

## **R. IRC 4943 - TRANSITIONAL RULES AND OTHER CURRENT TOPICS**

### Introduction

The most complicated of the major foundation excise tax provisions of Chapter 42, enacted by the 1969 Tax Reform Act (P.L. 91-172, 1969-3 C.B. 10), IRC 4943, has been, in the most part, the least considered provision. This is generally due to the liberal grace or transitional divestiture periods provided for disposing of excess business holdings held by private foundations on May 26, 1969.

The lack of interest is likely to change and the IRC 4943 area will become much more active since the shortest of the grace periods, the 10 year period provided for in IRC 4943(c)(4)(B)(iii), expires for many private foundations on May 26, 1979. Because of likely increased activity, this topic is included in the 1979 EOATRI, emphasizing issues of potential current interest.\* This IRC 4943 topic compliments the 101(1)(2) topic, also included in this EOATRI. The latter topic is of particular value because of its discussion of savings provision 101(1)(2)(B), dealing with the exception from IRC 4941 self-dealing for certain sales of private foundation excess business holdings, held on May 26, 1969, to disqualified persons.

Finalized regulations under IRC 4943 were published on July 5, 1977 (T.D. 7496, 1977-2 C.B. 390). The 1978 EOATRI textbook provided a general explanation of the IRC 4943 regulations. Of additional interest in this area are certain portions of the regulations dealing with the 5-year transitional rules of IRC 4943(c)(6) and "purchase" transactions, certain corporate readjustments and acquisitions, and holding corporation issues, which have been reserved.

Also of interest in this area is the fact that the National Office is presently developing Chapter 15 of the PFHB (IRM 7752) on IRC 4943.

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\*See Philanthropy Monthly, for October 1978 p. 5, and Taxes for October 1978 at p. 647.

## 1. General and Permitted Holdings

Generally, IRC 4943 imposes a tax on the excess business holdings in a business enterprise of a private foundation. Excess business holdings are those holdings which the private foundation would have to dispose of or cause the disposition of to a person other than a disqualified person in order for the remaining holdings of the private foundation to be permitted holdings. The initial tax is five percent of the value of the excess business holdings. If the excess holdings are not disposed of after the initial tax has been imposed, the private foundation becomes, after the expiration of the correction period (as extended), liable for an additional tax equal to 200 percent of the remaining excess business holdings.

The tax on excess business holdings does not apply to holdings in a functionally related business or in a trade or business which derives at least 95 percent of its gross income from passive sources. IRC 4943(d)(4). Regs. 53.4943-10(b) and 53.4943-10(c). 1978 EOATRI Textbook, page 117.

Generally, in determining if a trade or business derives at least 95 percent of its gross income from passive sources, its income during its last completed taxable year is considered. In case of a failure to meet the last completed year's test, Regs. 53.4943-10(c) provides a 10 year averaging rule that may be used to establish that an organization has derived its income primarily from passive sources. If the trade or business meets the 10 year rule, it will not be classified as a business enterprise subject to the IRC 4943 provisions.

In this regard, this ten year rule is intended to be used solely to shield organizations from the IRC 4943 provisions, and not as a sword. For example, for purposes of the 101(1)(2)(B) savings provision, involving the sale of certain pre-1970 excess business holdings to disqualified persons without such transactions being subject to the IRC 4941 self-dealing tax, arguments should not be entertained that the 10 year test may be used, in lieu of the last taxable year test, to characterize otherwise passive holdings as excess business holdings. The characterization of otherwise passive holdings as excess business holdings would, in such a case, allow sales to be made to disqualified persons in contravention of the IRC 4941 self-dealing provisions.

The rules for determining the permitted holdings of a private foundation in a business enterprise are presented in IRC 4943(c)(2) and 4943(c)(4). Basically, IRC 4943(c)(2) limits the combined holdings of a private foundation and all

disqualified persons to 20 percent of the voting stock (or profits interest for partnerships or joint ventures, and in all other cases, beneficial interest) in a business enterprise. Total holdings of 35 percent are allowed where one or more third persons, who are not disqualified persons, have effective control of the business enterprise.

Non-voting stock (or capital interest in the case of holdings in a partnership or joint venture) is a permitted holding of a foundation in any case where disqualified persons hold no more than 20 percent (or 35 percent as described above) of the voting stock of the corporation, and where total holdings of the foundation and all disqualified persons do not exceed the IRC 4943(c)(2) limitations. All equity interests which are not voting stock shall be classified as non-voting stock. See Regs. 53.4943-3(b)(2).

A private foundation is not permitted any holdings in sole proprietorships that are business enterprises (not functionally related nor 95 percent passive in nature) unless they were held on May 26, 1969, or acquired by gift or bequest thereafter. See IRC 4943(c)(3)(B), Regs. 53.4943-3(c)(3) and Regs. 53.4943-10(e). This means, for example, that if a private foundation operates, by itself, a trade or business, such as the operation of a commercial manufacturing, sales, or service activity, the foundation may be in violation of the IRC 4943 provisions, unless protected by one of the transitional provisions.

## 2. May 26, 1969 Excess Business Holdings - Transitional Rules

IRC 4943(c)(4) provides special transitional rules for holdings held on May 26, 1969. The percentage of combined permitted holdings with respect to stock held on May 26, 1969, is equal to the actual holdings on that date, but in no event shall the percentage exceed 50 percent for purposes of holdings held after the first phase, as discussed below. IRC 4943(c)(4) provides for phased reductions in the holdings in order to reduce actual holdings to the permitted percentage of holdings.

During the first phase, business interests owned by a private foundation on May 26, 1969, if the foundation has excess business holdings under the rules of IRC 4943(c)(2) on that date, are treated as held by a disqualified person, rather than by the foundation. The first phase lasts 20 years if the May 26, 1969, holdings of a private foundation alone exceeded 95 percent of the voting stock of a business corporation. The first phase lasts 15 years if the combined holdings of a private foundation and all disqualified persons in a business enterprise exceeded 75 percent of the voting stock of the value of all outstanding shares of stock of a

corporation, or 75 percent of the profits or capital interests of an unincorporated business on May 26, 1969. In all other cases, i.e., between 20 percent and 75 percent holdings, the first phase is 10 years. Phase one is suspended during certain judicial proceedings. IRC 4943(c)(4)(C). Regs. 53.4943-4(c)(3). No other provisions for the suspension of phase one are included in the Code or Regs.

During the first phase, the combined holdings must be reduced so that by the end of the first phase they do not exceed either 50 percent of the voting stock or 50 percent of the value of all outstanding shares of all classes of stock of a corporation (or 50 percent of comparable interests in an unincorporated enterprise). Present combined holdings in excess of 20 percent but less than 50 percent need not be decreased during the first phase but also may not be increased. However if the holdings of all disqualified persons together exceed two percent, the holdings of the foundation cannot exceed 25 percent, as discussed below, after termination of the first phase.

The 20 year period shall apply with respect to any interest which a private foundation holds in a sole proprietorship on May 26, 1969. Regs. 53.4943-4(c)(2).

The second phase is the 15 year period immediately following the first phase. If at any time during the second phase all disqualified persons together have holdings in excess of two percent of the voting stock of a business enterprise, then the holdings of the private foundation are limited to 25 percent of the voting stock and 25 percent of the value of all outstanding shares of all classes of stock of the business enterprise. The foundation must reduce its holdings to the 25 percent levels as soon as the holdings of its disqualified persons exceed two percent.

The third phase is the entire period following the second phase. During the third phase the manner of determining the permitted holdings of a private foundation to which 4943(c)(4) applies shall be the same as during the second phase with one exception. If a foundation enters the third phase, and the 25 percent limitation of the second phase never applied because disqualified persons had never held over two percent of the voting stock of a business enterprise at any time during the second phase, then the total combined permitted holdings of the private foundation and all disqualified persons is 35 percent during the third phase. Also, if disqualified persons subsequently acquire more than two percent of the voting stock, then the allowable holdings are further limited to a total of 35 percent, of which not more than 25 percent of the voting stock and 25 percent of the value of all outstanding shares of all classes of stock shall be held by the private foundation.

IRC 4943(c)(5) provides that certain holdings acquired pursuant to the terms of a trust which was irrevocable on May 26, 1969, and under the terms of a will executed on or before such date, which are in effect on May 26, 1969 and at all times thereafter, will be treated as if held by the private foundation on May 26, 1969. The 10 or 15 year first phase commences from the date of distribution, rather than from May 26, 1969. Note that the 20 year first phase period is not applicable in the IRC 4943(c)(5) situation. See Regs. 53.4943-5.

NOTE: Certain dispositions of excess business holdings required during these phases are provided special treatment under sections 101(1)(2)(B), 101(1)(3)(D), and 101(1)(8) of the Tax Reform Act of 1969, and are discussed in topic Q, p. 402-430 of this EOATRI textbook.

### 3. Additional Transitional Periods

#### a. 90 Day Rule

Regs. 53.4943-2(a)(ii) provides that where a private foundation acquires excess business holdings, other than as a result of a purchase by the foundation, the foundation will not be subject to IRC 4943 taxation if it no longer has such excess business holdings within 90 days from the date on which it knows, or has reason to know, of the event which caused it to have such excess business holdings. This provision is generally intended to cover those situations in which a disqualified person purchases business holdings, the purchase of which causes a private foundation's holdings to become excess business holdings. This 90 day period may be extended when required by federal or state securities laws. Regs. 53.4943-2(a)(iii).

#### b. Acquisitions Other Than By Purchase Rule

IRC 4943(c)(6) and Regs. 53.4943-6 provide a 5 year period for the disposition of excess business holdings acquired by a private foundation, other than by purchase by the foundation or a disqualified person, after May 26, 1969, such as through a gift or bequest to the private foundation. (This is distinguished from bequests from certain pre-1970 wills, etc., discussed above, which fall under the 10 and 15 year first phase periods.) The foundation's business holdings are treated as being held by a disqualified person, rather than by the foundation itself, during the 5 year period beginning on the date the foundation obtains the holdings.

This provision may also apply to increases in business holdings resulting from a merger, recapitalization, or other reorganization involving one or more business enterprises. For example, private foundation P holds 10 percent of the voting stock of corporation X, and disqualified persons hold 10 percent of the voting stock of X. Neither P, nor its disqualified persons, or both together have effective control over X. During 1979, X redeems 20 percent of its total outstanding voting stock from shareholders who are not disqualified persons. As a result of this redemption, P's holdings in X are increased to 12.5 percent of the voting stock, and the disqualified person's holdings are similarly increased to 12.5 percent of the voting stock. Since the total holdings of X and all disqualified persons exceed the 20 percent limitation of IRC 4943(c)(2) after the redemption, P is now in an excess business holdings position. However, since the increase in holdings did not result from a purchase of stock by P or a disqualified person, the provisions of IRC 4943(c)(6) are likely applicable, and the holdings of P in X would be treated as held by disqualified persons during a 5 year transitional period. P must dispose of its excess business holdings, in this case 2.5 percent, prior to the end of the 5 year period in order to avoid taxation under IRC 4943.

Another situation in which IRC 4943(c)(6) might apply is where an interest in a corporation or partnership that is not presently an interest in a business enterprise becomes at sometime in the future an interest in a business enterprise. For example, private foundation M owns 25 percent of the voting stock of corporation Y. Disqualified persons own 15 percent of the voting stock of Y. A, an individual who is not a disqualified person, owns the remaining 55 percent of the Y voting stock and exercises effective control over Y's activities. Y has received, in each year since 1969, over 95 percent of its gross income from passive sources. Consequently, it is not a "business enterprise" for purposes of IRC 4943. However, during 1979, economic conditions change and Y received less than 95 percent of its income from passive sources. Consequently, and assuming that the 10 year averaging rule of 53.4943-10(c) will not alter the result, Y is treated as a "business enterprise" for IRC 4943 purposes beginning in the year 1979. As a result, M is in an excess business holdings position. However, since the creation of the excess business holdings did not arise from a purchase by M or any disqualified person, IRC 4943(c)(6) is likely applicable, giving M a 5 year grace period to dispose of its excess business holdings in Y.

Also, it is interesting to note here that even if M and the disqualified persons had held their interests in Y since May 26, 1969, M probably could not take advantage of the present holdings rules of IRC 4943(c)(4). Rather, the permitted holdings would likely have to be determined by applying the general rules of IRC

4943(c)(2). This result arises because Y was not a "business enterprise" on May 26, 1969. Consequently, M did not have excess business holdings on May 26, 1969, as is required before IRC 4943(c)(4) becomes applicable.

The examples above share in common the fact that the foundation and its disqualified persons do not control the business enterprises considered, at least by weight of combined voting power. Where the facts indicate that control by the foundation or disqualified persons exists, and changes, reorganization, etc., result in increases of voting power or stock value, the IRC 4943(c)(6) five year rule may be inapplicable.

The regulations under IRC 4943 defining the term "purchase" and related matters, involving issues similar to the issues discussed in the hypotheticals above, are reserved. Currently, it is the policy of the National Office, under the general authority of section 3.05 of Rev. Proc. 72-3, 1972-1 C.B. 698, that no proposed transaction private ruling letters or technical advice memos that would be adverse to the taxpayer will be issued on matters covered by this and the other reserved portions of the IRC 4943 regulations. It is expected, however, that final regulations in the "purchase" area will have only prospective effect.

#### c. Post-1969 and Pre-1973 Acquisition Rule

A third transitional period is provided for in Regs. 53.4943-11(b). This provides that in the case of any acquisition, i.e., a purchase of excess business holdings after the enactment of IRC 4943 and prior to February 2, 1973, taxation under IRC 4943 will not be incurred if correction is completed within a period ending 90 days after July 5, 1977, (the date of publication of final IRC 4943 regulations) extended (prior to the expiration of the original period) by any period which the Commissioner determines is reasonable and necessary to bring about such correction.

Although obviously limited in applicability, and probably of little meaning now, it should be noted that this is the only transitional period for the disposition of excess business holdings that can be extended (other than the extension of the 90 day period of Regs. 53.4943-2(a)(iii) when required by federal or state securities laws). Authority to extend the period under the transitional rule of Regs. 53.4943-11(b) has been delegated to the key District Directors and Assistant Regional Commissioners (Examination). Del. Order No. 139 (Rev. 4), 43 F.R. 29651, July 2, 1978, 1978-34 I.R.B. 25.

#### 4. Extensions of Correction Period

If a private foundation fails to dispose of its excess business holdings during the applicable transitional period, as discussed above, or if a private foundation acquires excess business holdings in a transaction not protected by the transitional rules, the foundation becomes liable for the initial 5 percent tax. Following the imposition of this tax, correction is required. The foundation must dispose of its excess business holdings before the end of the correction period. The correction period ends 90 days after the date of mailing of a notice of deficiency under IRC 6212 with respect to the initial tax. This period can be extended while the private foundation files a claim for a refund of the initial tax, and for any period which the Commissioner determines is reasonable and necessary to permit orderly disposition of excess business holdings. IRC 4943(d)(3). Regs. 53.4943-9(b). Authority to extend the correction period under Regs. 53.4943-9(b) has been delegated to the key District Directors and Assistant Regional Commissioners (Examination) by Del. Order No. 139 (Rev. 4), noted above.

#### Conclusion

The discussion above indicates that IRC 4943 is a difficult, complex provision. In the past, primarily because of the liberal transitional rules provided under IRC 4943, relatively few cases have dealt with its provisions. As the transitional periods expire, an increase in activity should occur. Consequently, it is important to develop a general understanding of IRC 4943 so that it can be adequately enforced in future years.